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Appropriations for the Treasury Department and Internal Revenue Service in FY2006: Issues for Congress

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Summary

The Treasury Department performs a host of critical functions as a federal agency. Foremost among them are protecting the nation's financial system from a variety of financial crimes, administering the tax code and collecting tax revenue, managing and accounting for the public debt, administering the government's finances, and regulating and supervising financial institutions.

This report examines the President's budget request for Treasury and the Internal Revenue Service (IRS) in FY2006, some of the key policy issues it raised, and congressional action on the request. It will not be updated again.

For FY2006, the Bush Administration asked Congress to provide $11.648 billion in appropriated funds for Treasury, or 3.8% more than the amount enacted for FY2005. As usual, the vast share of the proposed budget was to go to the IRS, which would have received $10.679 billion. The remaining departmental offices and bureaus would have received the following amounts: departmental offices, $195 million; departmental systems and capital investments, $24 million; Office of Inspector General, $17 million; Inspector General for Tax Administration, $133 million; Air Transportation Stabilization program, $3 million; Community Development Financial Institutions Fund, $8 million; Treasury building and annex repair and restoration, $8 million; Financial Crimes Enforcement Network, $74 million; Financial Management service, $236 million; Alcohol and Tobacco Tax and Trade Bureau, $91 million; and the Bureau of the Public Debt, $177 million.

The Administration budget request for IRS operations ($10.679 billion) in FY2006 was 4.3% more than the amount enacted for FY2005. To better align the request with the IRS's current five-year strategic plan, the Administration sought to revise the agency's budget beginning in FY2006. Under its proposal, the number of accounts would be reduced from six to three: tax administration and operations (TAO), business systems modernization (BSM), and administration of the health insurance tax credit. For FY2006, the Administration asked that $10.460 billion be spent on TAO, or 4.6% more than was spent for this purpose in FY2005; $199 million on BSM, or 2.3% less than the amount enacted for FY2005; and $20 million on administration of the health care tax credit, or 41.5% less than the amount enacted for the current fiscal year. Compared to the amounts enacted for FY2005, the Administration sought $500 million more for enforcement but $39 million less for taxpayer service and $4 million less for BSM.

The House and Senate approved somewhat differing versions of an FY2006 appropriations bill (H.R. 3058) that included Treasury and the IRS. As a result, the differences had to be resolved in a conference committee. Under the conference agreement passed by the House and Senate on November 18, 2005, and signed by President Bush on November 30, Treasury is receiving $11.689 billion in funding (or about $40 million more than the amount requested by the Administration); nearly 91% of that amount, or $10.671 billion, is set aside for the IRS.

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This report examines the President's budget request for the Treasury Department and its largest operating bureau, the Internal Revenue Service (IRS), in FY2006, congressional action on the request, and some of the key policy issues it raised.[1]

Department of the Treasury

Organizational and Functional Profile

In recent decades, the Treasury Department has played four specific roles: (1) formulating, recommending, and implementing economic, financial, tax, and fiscal policies; (2) serving as the sole financial agent for the federal government; (3) enforcing federal financial, tax, counterfeiting, customs, tobacco, alcoholic beverage, and gun laws; and (4) producing postage stamps, currency, and coinage.

The creation of the Department of Homeland Security (DHS) in late 2002 and its assumption of the authorities and duties transferred to it by executive order in March 2003 drastically reshaped Treasury's functional profile.[2] While Treasury still exerts a strong influence over economic policymaking within the executive branch and still serves as the government's financial manager, revenue collector, and producer of currency and coinage, its role in law enforcement is much more circumscribed.

At its most basic level of organization, the department is comprised of departmental offices and operating bureaus. In general, the departmental offices are responsible for the formulation and implementation of policy initiatives and the management of departmental operations; the operating bureaus, in contrast, carry out specific tasks assigned to the department, largely through statutory mandates. The bureaus typically account for more than 95% of the department's personnel and funding.

With one notable exception, the bureaus may be divided into those focused on financial matters and those engaged in law enforcement. In recent decades, the following Treasury bureaus have all contributed to the management of federal finances or the daily operation of the U.S. financial system: Comptroller of the Currency, U.S. Mint, Bureau of Engraving and Printing, Financial Management Service, Bureau of Public Debt, Community Development Financial Institutions Fund (CDFI), and Office of Thrift Supervision. At the same time, law enforcement has been central to the main responsibilities assigned to the following current or former Treasury bureaus: Bureau of Alcohol, Tobacco, and Firearms (BATF), U.S. Secret Service, Federal Law

[1] For a summary of the Administration's budget request in tabular form, see CRS Report RL32905, *Transportation, the Treasury, Housing and Urban Development, the Judiciary, the District of Columbia, the Executive Office of the President, and Independent Agencies: FY2006 Appropriations*, David Randall Peterman coordinator.

[2] See U.S. President (Bush), "Amendment of Executive Orders, and Other Actions, in Connection With the Transfer of Certain Functions to the Secretary of homeland Security," Executive Order 13286, *Federal Register*, vol. 68, Mar. 5, 2003, pp. 10619-10633.

Enforcement Training Center, U.S. Customs Service, Financial Crimes Enforcement Network (FinCEN), and Treasury Forfeiture Fund. The exception to this simplified dichotomy is the Internal Revenue Service (IRS), which is involved in both the collection of tax revenue and the enforcement of federal tax laws and regulations.

As noted above, the creation of DHS greatly diminished Treasury's role in law enforcement. Under the law establishing DHS (P.L. 107-296), the Secret Service, Customs Service, and Federal Law Enforcement Training Center were transferred from Treasury to DHS, while the Treasury Forfeiture Fund and many of the law enforcement duties of BATF were transferred to the Justice Department (DOJ). In addition, in January 2003, the Treasury Department established a new bureau to administer laws governing the use of alcohol and tobacco and implement regulations formerly handled by BATF: the Alcohol and Tobacco Tax and Trade Bureau. Its main tasks do not involve law enforcement: collecting alcohol and tobacco excise taxes, classifying those products for tax purposes, and regulating the operations of industrial users of distilled spirits.

The operations of most Treasury bureaus are funded through annual appropriations passed by Congress. This is true of the IRS, Financial Management Service, Bureau of the Public Debt, departmental offices, FinCEN, Alcohol and Tobacco Tax and Trade Bureau, Office of Inspector General, Treasury Inspector General for Tax Administration (TIGTA), CDFI, and Treasury's international programs. But a handful of bureaus finance their operations largely through the collection of fees for the services and products they provide. This funding arrangement applies to the Treasury Franchise Fund, U.S. Mint, Bureau of Engraving and Printing, Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Budget in FY2005 and Proposed Budget in FY2006

In FY2005, Treasury received $11.218 billion in appropriated funds, an amount that was 1.1% more than it received in FY2004 (see **Table 1**). About 91% of these funds were used to finance the operations of the IRS, whose budget was set at $10.236 billion. The remaining $982 million was distributed in the following manner among Treasury's other bureaus and its departmental offices: departmental offices (including TFI), $156 million; OFAC, $22 million; department-wide systems and capital investments, $32 million; Office of Inspector General, $16 million; TIGTA, $128 million; Air Transportation Stabilization program, $2 million; CDFI, $55 million; Treasury building and annex repair and restoration, $12 million; FinCEN, $72 million; Financial Management Service, $229 million; Alcohol and Tobacco Tax and Trade Bureau, $82 million; and Bureau of the Public Debt, $174 million. These amounts reflected an 0.83% across-the-board cut (or rescission) in non-defense discretionary spending that was included in the law funding the Treasury Department and most other federal agencies in FY2005: the Consolidated Appropriations Act, 2005 (P.L. 108-447).

For FY2006, the Bush Administration asked Congress to provide $11.649 billion in appropriated funds for Treasury operations—or 3.8% more than the amount enacted for FY2005 (see **Table 1**). Once again, the vast share of this requested amount was to go to the IRS, whose budget would have totaled $10.679 billion. The other departmental offices and bureaus would have received the following amounts: departmental offices, $195 million; departmental systems and capital investments, $24 million; Office of Inspector General, $17 million; TIGTA, $133 million; Air Transportation Stabilization program, $3 million; CDFI, $8 million; Treasury building and annex repair and restoration, $10 million; FinCEN, $74 million; Financial Management Service, $236 million; Alcohol and Tobacco Tax and Trade Bureau, $62 million; and Bureau of the Public Debt, $177 million. All accounts—except those for departmental systems and capital investments and Treasury building and annex repair and restoration—would have been funded at higher levels than in FY2005. The Administration also requested that funding for OFAC be treated not as a separate account but as part of the account for departmental offices. Under the Administration's budget proposal, total full-time employment at Treasury was projected to rise to 113,242 from 113,002 in FY2005.[3]

Congressional action on the Administration's budget request for FY2006 commenced in the House with a series of hearings held by the House Appropriations Subcommittee on Transportation, Treasury, Housing and Urban Development, the Judiciary, and District of Columbia in March, April, May, and June of this year. On June 15, the Subcommittee approved by voice vote a measure (H.R. 3058) to provide funding for Treasury and a handful of other federal agencies in FY2006. The Appropriations Committee also voted by voice vote to report favorably (H.Rept. 109-153) to the House an amended version of H.R. 3058 on June 21. Following the consideration of 48 amendments spread over two days of floor debate, the House approved the measure on June 30 by a vote of 405 to 18 and sent it on to the Senate.

As passed by the House, H.R. 3058 would have given Treasury $11.529 billion in funding for FY2006, or $311 million more than the amount enacted for FY2005 but $120 million less than the amount requested by the Bush Administration. The IRS was to receive $10.556 billion, or $320 million more than its budget in FY2005 but $123 million less than the amount requested by the Administration. The House denied a request by the Administration to combine funding for taxpayer service, tax law enforcement, and information systems into a new single account for tax administration and operations. In addition, H.R. 3058 would have increased funding in FY2006 relative to FY2005 for the following accounts and in the following amounts: Alcohol and Tobacco Tax and Trade Bureau, +$9 million; the Financial Management Service, +$7 million; TIGTA, +$5 million; Bureau of the Public Debt, +$3 million; FinCEN, +$2 million; and departmental offices (which includes OFAC and TFI) and Office of Inspector General, +$1 million. Three accounts would have been funded at lower levels in FY2006 than in FY2005: department-wide systems and capital investments, -$11 million; Treasury building and annex repair and restoration, -$2 million; and CDFI, -$0.1 million. One current account would have received no funding under the measure: the Air Transportation Stabilization program.

In the Senate, the Appropriations Committee favorably reported (S.Rept. 109-109) an amended version of H.R. 3058 as passed by the House by a vote of 28 to 0 on July 21. Following three days of debate and the consideration of over 130 amendments, the Senate approved by a vote of 93 to 1 on October 20 a version of H.R. 3058 that differed in some important ways from the House-passed version.

Under the version of H.R. 3058 approved by Senate, the Treasury Department would have received $11.698 billion in funding in FY2006—or $480 million more than the amount enacted for FY2005, $49 million more than the amount requested by the Bush Administration, and $169 million more than the amount approved by the House. The IRS would have received $10.679 billion—or $443 million more than the amount enacted for FY2005, the same amount requested by the Administration, and $123 million more than the amount approved by the House. Like the House, the Committee rejected an Administration proposal to combine funding for taxpayer service, tax law enforcement, and information systems into a new single account for tax administration and operations. But unlike the House, the Senate elected to give the IRS the same amount for tax law enforcement that was requested by the Administration: $4.726 billion. In addition, the following accounts would have received an increase in funding relative to their budgets for FY2005: departmental offices (including OFAC and TFI), +$42 million; Alcohol and Tobacco Tax and Trade Bureau, +$9 million; the Financial Management Service, +$7 million; TIGTA, +$5 million; the Bureau of Public Debt, +$3 million; FinCEN, +$2 million; and Office of

[3] U.S. Treasury Department, *Budget in Brief FY 2006* (Washington: Feb. 2005), p. 8.

Inspector General and Air Transportation Stabilization program, +$1 million. Funding for three Treasury accounts would have been cut relative to the amounts enacted for FY2005: department-wide systems and capital investments, -$8 million; Treasury building and annex repair and restoration, -$2 million; and CDFI, $-0.1 million. Furthermore, the Senate-passed version of H.R. 3058 would also have restored funding for two programs that were effectively eliminated in FY2005: expanded access to financial services ($4.0 million) and violent crime reduction ($1.2 million).

The significant differences between the versions of H.R. 3058 passed by the House and Senate meant that a conference committee had to be formed in order to resolve those differences. In late October, such a committee was formed, and it came to an agreement on the bill that was detailed in a conference report (H.Rept. 109-307) released on November 18. Later the same day, the House approved the report by a vote of 392 to 31, and the Senate did likewise through a procedure known as unanimous consent. President signed the measure (P.L. 109-115) on November 30.

Under the conference agreement on H.R. 3058, Treasury is receiving $11.689 billion in appropriated funds in FY2006—or $471 million more than it received in FY2005. Of this amount, $10.672 billion goes to the IRS—or $436 million more than it received in FY2005. The conference report specifies that the IRS may reorganize or reduce its workforce only with the consent of the House and Senate Appropriations Committees. Moreover, Treasury's departmental offices are receiving $197 million, $40 million of which is to be used to combat financial crimes (including the financing of terrorist operations). The remaining accounts are funded at the following levels: department-wide systems and capital investments, $24 million; Office of Inspector General, $17 million; TIGTA, $133 million; Air Transportation Stabilization program, $3 million; Treasury building and annex repair and restoration, $10 million; FinCEN, $74 million; Financial Management Service, $236 million; Alcohol and Tobacco Tax and Trade Bureau, $91 million; Bureau of Public Debt, $177 million; and CDFI, $55 million (to be available until September 30, 2007).

Table 1. Department of Treasury Appropriations, FY2004 to FY2006

(millions of dollars)

Account or Program	FY2004 Enacted[a]	FY2005 Enacted[b]	FY2006 Request	FY2006 House-passed	FY2006 Senate-reported	FY2006 Enacted
Departmental Offices	175	156	195	157	198	197
Office of Foreign Asset Control	—	22	—	—	—	—
Department-Wide Systems and Capital Investments	36	32	24	21	24	24
Office of Inspector General	13	16	17	17	17	17
Treasury Inspector General for Tax Administration	127	128	133	133	133	133
Air Transportation Stabilization Program	3	2	3	—	3	3

Account or Program	FY2004 Enacted[a]	FY2005 Enacted[b]	FY2006 Request	FY2006 House-passed	FY2006 Senate-reported	FY2006 Enacted
Community Development Financial Institutions Fund	61	55	8	55	55	55
Treasury Building Annex Repair and Restoration	25	12	10	10	10	10
Financial Crimes Enforcement Network	57	72	74	74	74	74
Financial Management Service	227	229	236	236	236	236
Alcohol and Tobacco Tax and Trade Bureau	80	82	62	91	91	91
Bureau of the Public Debt	173	174	177	177	177	177
Internal Revenue Service	10,205	10,237	10,679	10,556	10,679	10,672
Total Appropriations, Treasury Department	**11,100**	**11,218**	**11,649**	**11,529**	**11,698**	**11,689**

Source: Figures are from a budget authority table provided by the House Committee on Appropriations with one exception. The figures for the Senate Committee on Appropriations come from S.Rept. 109-109. Columns may not sum to the total shown at the bottom because of rounding or the exclusion of certain relatively small line-items.

a. FY2004 figures reflect an across-the-board rescission of 0.59%.

b. FY2005 figures reflect an across-the-board rescission of 0.83%.

Issues for Congress

According to budget documents, the Administration's FY2006 budget request for the Treasury Department was intended to support a variety of strategic objectives. Heading the list were improving taxpayer compliance with tax laws; modernizing IRS's computer and management systems; enhancing Treasury's capability to analyze and disrupt terrorist financing and financial crimes; maintaining and safeguarding the integrity of federal finances and the U.S. financial system; and increasing opportunities for economic development through policy initiatives such as enacting permanent tax cuts and fundamental tax reform. This section examines some of the key policy issues raised by the Administration's budget request for Treasury operations except the IRS. Many of these issues are tied to the Department's strategic objectives. The policy issues raised by the budget request for the IRS are examined in a subsequent section.

Combating Terrorist Financing

Not surprisingly, recent congressional testimony by senior Treasury officials indicates that one of their highest priorities is uncovering, monitoring, and disrupting or stopping the flow of funds to terrorist groups.[4]

[4] See the prepared testimony of Treasury Secretary John W. Snow before the Senate Appropriations Subcommittee on

In the wake of the terrorist attacks of September 11, 2001, Treasury has taken several noteworthy steps to extend and restructure its involvement in the federal government's evolving campaign to uproot the financing of terrorist groups hostile toward the United States and other financial crimes.

In March 2003, the Treasury Secretary announced the establishment of the Executive Office of Terrorist Financing and Financial Crimes (EOTF). From the outset, the Office's mission was to coordinate and direct Treasury's efforts to uncover and dismantle terrorist financing networks, combat a variety of financial crimes, implement certain key provisions of the Bank Secrecy Act of 1970 (BSA) and the USA Patriot Act, and represent the United States in international organizations dedicated to fighting terrorist financing and financial crimes. In carrying out this task, EOTF was authorized to draw on the resources of FinCEN and the Office of Foreign Assets Control (OFAC). It appears, however, that these plans never came to fruition.

About one year later, the Treasury Secretary announced the formation of another office to oversee and coordinate the department's contributions to the government's campaign against terrorist financing and other financial crimes: the Office of Terrorism and Financial Intelligence (TFI). TFI seeks to integrate the operations and resources of the Office of Terrorist Financing and Financial Crime (TF/FC), OFAC, FinCEN, the Office of Intelligence and Analysis (OIA), and the Treasury Executive Office for Asset Forfeiture. In essence, TFI has two basic responsibilities: (1) gathering and evaluating financial intelligence and (2) enforcing various financial laws and regulations. OIA provides the intelligence, mainly through the analysis of complex financial transactions. Enforcement is handled by TF/FC, OFAC, and FinCEN and includes such activities as identifying and freezing the bank accounts of terrorists, leaders of drug smuggling operations and their support networks; implementing U.S. sanctions policy; administering and enforcing the BSA; and fostering close working relationships between domestic law enforcement agencies and financial institutions around the aim of exposing or tracking illicit activities. Upon request, TFI also is authorized to assist IRS special agents in their investigations of allegations of terrorist financing, money laundering, and other financial crimes.

The Administration's proposed budget for Treasury in FY2006 seeks to bolster the agency's role in the campaign against terrorist financing. It asked Congress to increase funding for programs within the Treasury Department dedicated to combating financial crimes (including terrorist financing) from an estimated $25 million in FY2005 to $40 million in FY2006, a rise of 60%. More than half of this money ($22 million) was to be funneled into OFAC and the remainder to TFI. Congress evidently agreed with this approach: the enacted version of H.R. 3058 included $40 million for these programs.

The Administration's request to increase substantially spending on Treasury programs to combat terrorist financing and other financial crimes raised significant questions about how these additional funds would be spent, what they would mean for Treasury's role in the federal government's campaign to combat terrorist financing networks, and whether the likely benefits from the increased spending would outweigh the cost of expanding the programs. More specifically, would the proposed budget for countering financial crimes enhance Treasury's capability to analyze and disrupt terrorist financing? How would the proposed budget fit into the federal government's diversified and evolving campaign against terrorist financing? Would the activities to be undertaken by TFI in FY2006 duplicate any of the contributions of other Treasury bureaus (particularly FinCEN) and other federal agencies (particularly the Department of Justice or the Federal Bureau of Investigation)? If so, to what extent? What are the expected benefits of

Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies on April 26, 2005. Available at http://www.treas.gov/press/archive.html.

expanding Treasury's programs to counter terrorist financing and how do they compare to the additional cost of such an expansion?

The Administration provided few details in its budget documents that addressed any of these questions.[5]

Some Members of Congress had similar questions about Treasury's plans to increase its involvement in the campaign against terrorist financing. In its report to the House on H.R. 3058, the Committee on Appropriations expressed concern about the purpose of TFI and its role in the government's campaign against terrorist financing.[6] Future congressional oversight of the TFI and related Treasury programs may wish to focus on these policy questions.

Administration of the Community Development Financial Institutions Fund

The Administration's FY2006 budget request for the Treasury Department included a reduction in funding for the Community Development Financial Institutions Fund (CDFI) from $55.1 million in FY2005 to $7.9 million in FY2006. To say the least, the proposal provoked a controversy over its merits.

Since its inception, the CDFI, which was created by the Riegle Community Development and Regulatory Improvement Act of 1994, has sought to increase the availability of credit, investment capital, and financial services in relatively poor urban and rural communities. The fund pursues these objectives by augmenting the private resources for investment in economic development, affordable housing, and basic banking services in these communities. It works with two sets of partners in boosting such investment: private financial institutions certified by the CDFI as community development financial institutions and private equity groups certified by the CDFI as community development entities (CDEs).

Under the Administration's proposal, three core elements of the CDFI—Native Initiatives, Bank Enterprise Award Program, and Community Development Financial Institutions Program—would have been consolidated within the Commerce Department with at least 17 other federal community and economic development programs.[7] In taking such a step, the Administration has said it was trying to "achieve greater results and focus on communities most in need of assistance." No additional funding for loans and grants was proposed for the CDFI programs that were to be transferred to the Commerce Department. It was not clear from the Administration's budget documents whether funding for these programs would be cut relative to spending on them in recent fiscal years. What was clear was that the $7.9 million requested for CDFI in FY2006 would have enabled the fund to continue administering the so-called "new markets" tax credit created by the Community Renewal Tax Relief Act of 2000 and manage its existing portfolio of loans and grants. The credit is intended to inject greater private investment into poorer

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[5] For example, in one of the primary documents presenting its budget request for FY2006, the Treasury Department describes the purpose and organizational structure of TFI but says little about the justification for the added funding it is requesting. See Treasury Department, *Budget in Brief FY2006* (Washington, 2005), pp. 37-41.

[6] U.S. Congress, House Committee on Appropriations, *Authorizing Appropriations for the Departments of Transportation, Treasury, and Housing and Urban Development, the Judiciary, District of Columbia, and Independent Agencies in FY2006*, report to accompany H.R. 3058, 109th Cong., 1st sess., H.Rept. 109-153 (Washington: GPO, 2005), p. 67.

[7] For more details on the Administration's proposed consolidation of federal community and economic development programs, see CRS Report RL32823, *An Overview of the Administration's Strengthening America's Communities Initiative*, by Eugene Boyd, Pauline Smale, Tadlock Cowan, Garrine Laney, and Bruce Foote.

neighborhoods with relatively high rates of poverty and unemployment through the medium of CDEs.

The Administration's proposal was sharply criticized on the grounds that it would undermine the prospects for needed economic development in poorer communities by effectively eliminating the CDFI programs to be transferred to the Commerce Department. Some feared the proposal would lead to a substantial loss of seed capital for small banks classified as community development financial institutions.[8] Among these critics were some Members of Congress. Their views apparently proved decisive in the congressional debate over the merits of the proposal: the enacted version of H.R. 3058 not only retained the current administrative structure for the CDFI but also provided it with $55.0 million in funding in FY2006 and FY2007, $6 million of which is for direct loans and $4 million of which is for technical assistance for native American, Hawaiian, and Alaskan communities.

A policy issue raised by the Administration's proposal—one that may have contributed to its defeat—was its impact on the communities that have benefitted from the CDFI programs the Administration wanted to consolidate within the Commerce Department. More specifically, the proposal led some to ask whether the proposed reorganization of the CDFI would trigger sharp declines in lending to small firms and investment in commercial real estate development and low-income housing and gradual retrenchments in the availability of financial services in these communities. Future congressional oversight of the CDFI may wish to assess the effects of its programs in the communities directly affected by them.

Funding for the Alcohol and Tobacco Tax and Trade Bureau

The Administration's FY2006 budget request also sought to charge user fees for some of the services provided by the Alcohol and Tobacco Tax and Trade Bureau. Two new fees were proposed: (1) an administrative fee for "drawbacks" from manufacturers of non-beverage products and (2) a filing fee for Certificate of Label Approvals for distilled spirits, wine, and beer, American Viticultural Areas, proposed formulas, and new permit applications. To make the adoption of the fees feasible, the Administration said it would seek the enactment of legislation giving the bureau the authority to collect the proposed fees. The Administration said the fees were warranted because they would compel the firms benefitting from the bureau's regulatory activities to bear at least some of the cost of these activities. Among the benefits cited by the Administration were the assurance that alcohol and tobacco products sold domestically were unadulterated and fair competition among firms subject to the regulations. The Administration estimated that the proposed fees would raise $28.6 million in revenue in FY2006.

Some opposed the proposed fees on the grounds that they would prove unduly burdensome for smaller firms, especially family-owned wineries. The opponents included some lawmakers. Evidently more than a few Members of Congress found this line of reasoning persuasive: the enacted version of H.R. 3058 rejected the proposed user fees.

In the minds of some, the Administration's proposal raised the broader policy question of under what circumstances is it appropriate for a federal agency to rely on user fees rather than appropriated funds to cover the cost of providing specific services.

[8] See Hannah Bergman and Laura Thompson Osuri, "Bush Budget Would Spell Pain for CDFIs," *American Banker*, vol. 170, no. 27, Feb. 9, 2005, p. 1.

Internal Revenue Service

In order to finance its operations and many of its programs, the federal government levies individual and corporate income taxes, social insurance taxes, excise taxes, estate and gift taxes, customs duties, and miscellaneous taxes and fees. The federal agency responsible for administering and collecting these taxes and fees (except customs duties) is the Internal Revenue Service (IRS). In discharging this responsibility, the IRS receives and processes millions of tax returns and related documents and payments; disburses refunds; enforces compliance through audits and other methods; collects delinquent taxes; and provides a variety of services to taxpayers to help them understand their rights and responsibilities and resolve problems. In FY2004, the IRS collected $2.035 trillion before refunds, the largest component of which was individual income tax revenue of $990 billion.

Budget in FY2005 and Proposed Budget in FY2006

In FY2005, the IRS received $10.236 billion in appropriated funds (see **Table 2**). This amount was 0.5% more than the amount enacted for FY2004. Of the amount enacted for FY2005, $4.057 billion was designated for processing, assistance, and management; $4.364 billion for tax law enforcement; $1.578 billion for information systems management; $203 million for the business systems modernization program (BSM); and $35 million to administer the health insurance tax credit established by the Trade Act of 2002. Of the funds appropriated for processing, assistance, and management, Congress specified that $4 million be used to operate the Tax Counseling for the Elderly program, and that $7.5 million be used as grants for low-income taxpayer clinics. None of the funds appropriated for the BSM program could be spent without the consent of the House and Senate Appropriations Committees. In addition, the IRS Commissioner was required to submit quarterly reports in FY2005 to both committees assessing the agency's "progress, status, and results in implementing its proposed compliance initiatives" during the fiscal year.[9]

The Bush Administration requested that IRS operations be funded at $10.679 billion in FY2006—or 4.3% more than the funding the agency received in FY2005 (see **Table 2**). To bring its proposed budget into closer alignment with IRS's major programs and most recent strategic plan, the Administration proposed that the agency's budget be restructured beginning in FY2006. Under the proposal, the number of appropriations accounts in the IRS budget would be reduced from six to three: tax administration and operations (TAO), BSM, and administration of the health insurance tax credit. TAO would be equivalent to the existing accounts for tax law enforcement; processing, assistance, and management; and information systems. For FY2006, the Administration sought $10.460 billion in appropriated funds for TAO—or about 5% more than was spent for this purpose in FY2005; $199 million for BSM—or 2% less than the amount enacted for FY2005; and $20 million for administration of the health insurance tax credit—or 43% less than the amount enacted for FY2005. Compared to the FY2005 budget, the Administration sought $500 million more for enforcement but $38 million less for taxpayer service and $4 million less for BSM. The Administration estimated that its budget proposal would have boosted total full-time employment at the IRS from 97,440 in FY2005 to 97,679 in FY2006.

In the first few months of 2005, the IRS disclosed how it planned to achieve the requested $38 million reduction in spending on taxpayer service. Most of the savings, the agency revealed, would come from the closure of 68 out of 400 Taxpayer Assistance Centers (TACs) and a

[9] U.S. Congress, Senate Committee on Appropriations, *Transportation, Treasury and General Government Appropriations Bill, 2005*, report to accompany S. 2806, 108th Cong., 2d sess., S.Rept. 108-342 (Washington: GPO, 2005), p. 149.

reduction in the weekly hours of operation for toll-free telephone assistance for taxpayers by the end of 2005. These disclosures sparked howls of protest from some, who feared that the planned cutbacks in service would make it much harder for many individual and business taxpayers to comply with the tax laws.

In a bid to ensure that the IRS got the requested funding for tax law enforcement of $6.893 billion, the Administration proposed that Congress fund IRS operations through a budgetary mechanism known as a contingency appropriation in FY2006. Under this method, caps are imposed on discretionary spending for all federal agencies in accordance with Section 302(a) of the Congressional Budget Act of 1974 and Section 251 of the Balanced Budget and Emergency Deficit Control Act of 1985. The Administration asked Congress to increase the cap on funding for the IRS in FY2006 by $446 million. According to existing budgetary rules, Congress could do so only if it specified that all additional funds be used for enforcement and approved a base level of funding for enforcement in FY2006 of $6.446 billion. Otherwise, the added $446 million could not be appropriated or made available to the IRS.[10]

A key player in the annual budget cycle for the IRS is the IRS Oversight Board. Under the Internal Revenue Service Restructuring and Reform Act of 1998 (RRA98, P.L. 105-206), the Board is authorized to review the agency's annual budget request, submit its own budget recommendation to the Treasury Department, and determine whether the budget submitted by the President to Congress is adequate to support the annual and long-term strategic plans of the IRS.[11]

The Board recommended a budget of $11.629 billion for the IRS in FY2006, an amount that was about 14% greater than the agency's budget in FY2005 and 9% greater than the budget requested by the Bush Administration for FY2006.[12] While acknowledging that the IRS had made significant progress in improving customer service and combating tax evasion in the past few years, the Board argued that more money should be appropriated than the Administration requested for enforcement (an additional $35 million), taxpayer service (an additional $111 million), BSM (another $140 million), and expected increases in IRS operating costs (another $87 million).

Congressional action on the Administration's FY2006 budget request for the IRS commenced in the House with a series of hearings held by the House Appropriations Subcommittee on Transportation, Treasury, Housing and Urban Development, the Judiciary, and District of Columbia in March, April, May, and June of 2005. On June 15, the Subcommittee approved by voice vote a measure (H.R. 3058) to provide funding for the Treasury Department (including the IRS) and certain other executive agencies in FY2006. The Appropriations Committee also voted by voice vote to report favorably (H.Rept. 109-153) to the House an amended version of H.R. 3058 on June 21. Following the consideration of a total of 48 amendments spread over two days of floor debate, the House approved the measure on June 30 by a vote of 405 to 18 and sent it on to the Senate.

As passed by the House, H.R. 3058 would have appropriated $10.556 billion for IRS operations in FY2006 (see **Table 2**), an amount that was $319 million more than the agency's budget in FY2005 but $123 million less than the amount requested by the Bush Administration. The House did not endorse the Administration's proposed restructuring of the IRS budget. As a result, it was

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[10] See Allen Kenney, "White House Budget Proposes Use-It-of-Lose-It IRS Funding," *Tax Notes*, Feb. 21, 2005, p. 885; and Stephen Joyce, "Administration's FY2006 Budget Includes mechanism to Boost Enforcement Funding," *Daily Report for Executives*, Bureau of National Affairs, Feb. 14, 2005, p. G-7.

[11] See 26 U.S.C. § 7802(d).

[12] IRS Oversight Board, *FY2006 IRS Budget: Special Report* (Washington: March 2005), pp. 9-10. Available at http://www.irsoversightboard.treas.gov.

difficult to make meaningful comparisons between the Administration's budget request and the funding for IRS operations included in the House-passed version of H.R. 3058. Nonetheless, it was possible to compare the funding approved by the House with the amounts enacted for FY2005. Of the $10.556 billion in funding for the IRS approved by the House, $4.182 billion (or $125 million above the level for FY2005) would have gone to processing, assistance, and management; $4.580 billion (or $216 million above the level for FY2005) to tax law enforcement; $1.575 billion (or $3 million below the level for FY2005) to information systems; $199 million (or $4 million below the level for FY2005) to the BSM program; and $20 million (or $15 million below the level for FY2005) to administering the health insurance tax credit. The measure also specified that of the funds recommended for processing, assistance, and management, $4 million was to be set aside for the Tax Counseling for the Elderly program, $8 million for grants to low-income taxpayer clinics, and $1.5 million for the IRS Oversight Board. In addition, the measure included a provision prohibiting the IRS from closing or consolidating any TACs until TIGTA had completed a "thorough study" that assessed the "impact of (planned) closures on taxpayer compliance."[13]

In the Senate, the Appropriations Committee favorably reported (S.Rept. 109-109) an amended version of H.R. 3058 by a vote of 28 to 0 on July 21. The Senate approved the bill with a few changes by a vote of 93 to 1 on October 20.

The version of H.R. 3058 passed by the Senate granted the IRS the same level of funding in FY2006 requested by the Administration: $10.679 billion, or $443 million more than the amount enacted for FY2005 and $123 million more than the amount approved by the House (see **Table 2**). Like the House, the Senate rejected the Administration's proposed restructuring of the IRS budget on the grounds that it was "overly simplistic" and hampered the ability of the Appropriation Committee to hold the IRS accountable for how it used appropriated funds. Under the Senate-passed version of H.R. 3058, the IRS would have received $4.137 billion for processing, assistance, and management (or $80 million more than the amount enacted for FY2005 but $45 million less than the amount approved by the House); $4.726 billion for tax law enforcement (or $362 million more than the amount enacted for FY2005 and $145 million more than the amount approved by the House); $1.598 billion for information systems (or $20 million more than the amount enacted for FY2005 and $23 million more than the amount approved by the House); $199 million for the BSM program (or $4 million less than the amount enacted for FY2005 but the same amount requested by the Administration and approved by the House); and $20 million for administering the health insurance tax credit (or $15 million less than the amount enacted for FY2005 but the same amount requested by the Administration and approved by the House). Like the House-passed version of H.R. 3058, the Senate-passed version also included a provision that would have barred the IRS from using any of the funds appropriated by the bill to implement any planned reduction in taxpayer services TIGTA had completed a study "detailing the impact of the IRS's plans to reduce services on taxpayer compliance and taxpayer assistance."[14] The Senate also agreed with the House in specifying that $4.1 million be set aside for the Tax Counseling for the Elderly program and $8 million for grants to low-income taxpayer clinics. But unlike the House-passed bill, the version passed by the Senate would have removed the cap imposed by the FY1995 Treasury, Postal Service and General Government Appropriations Act on the amount of user fees collected by the IRS in a fiscal year that it is allowed to retain and

[13] U.S. Congress, House Committee on Appropriations, *Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies Appropriations Bill, 2006*, report to accompany H.R. 3058, 109th Cong., 1st sess., H.Rept. 109-153 (Washington: GPO, 2005), p. 80.

[14] U.S. Congress, Senate Committee on Appropriations, *Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies Appropriations Bill, 2006*, report to accompany H.R. 3058, 109th Cong., 1st sess., S.Rept. 109-109 (Washington: GPO, 2005), p. 134.

would have prevented the IRS from competing with the private sector in developing tax return preparation software by requiring the agency to continue the Free File program begun in 2002.

Table 2. IRS Appropriations, FY2004 to FY2006

(millions of dollars)

Account or Program	FY2004 Enacted[a]	FY2005 Enacted[b]	FY2006 Request[c]	FY2006 House-passed	FY2006 Senate-passed	FY2006 Enacted
Processing, Assistance and Management	4,009	4,057	—	4,182	4,137	4,137
Tax Law Enforcement	4,171	4,364	—	4,580	4,726	4,726
Information Systems	1,582	1,578	—	1,575	1,598	1,599
Business Systems Modernization Program	388	203	199	199	199	199
Health Insurance Tax Credit Administration	35	35	20	20	20	20
Total, Internal Revenue Service	**10,205**	**10,237**	**10,679**	**10,556**	**10,679**	**11,672**[d]

Source: Figures are from a budget authority table provided by the House Committee on Appropriations. Columns may not sum to the total shown at the bottom because of rounding or the exclusion of relatively small line-items.

a. FY2004 figures reflect a rescission of 0.59%.

b. FY2005 figures reflect a rescission of 0.83%.

c. Under the Bush Administration's FY2006 budget request, three IRS appropriations accounts (i.e., processing, assistance and management; tax law enforcement, and information systems) would have been consolidated into a single account known as tax administration and operations (TAO). The Administration asked Congress to appropriate $10.460 billion for TAO in FY2006, or about 5% more than was spent for that purpose in FY2005.

d. Includes a rescission of $9 million.

The differences between the House-passed and Senate-passed version of H.R. 3058 must be resolved by a conference committee before a version of the bill can be sent to the President for his signature. Such a committee was formed in late October. On November 18, it released a conference report (H.Rept. 109-307) spelling out the terms of the agreement it reached. Later the same day, the House approved the conference agreement on H.R. 3058 by a vote of 392 to 31, and the Senate did likewise through a procedure known as unanimous consent. President Bush signed the measure on November 30.

Under the enacted version of H.R. 3058, the IRS is receiving $10.672 billion in FY2006, or $435 million more than it received in FY2005. Of this amount, $4.137 billion is being used for processing, assistance, and management; $4.726 billion for tax law enforcement; $1.599 billion for information systems; $199 million for BSM; and $20 million for administering the health insurance tax credit. The act specifies that the IRS may not reorganize or reduce its workforce without the consent of the House and Senate Appropriations Committees, and that the IRS may not eliminate or reduce any of the services it provides to taxpayers until TIGTA completes a study of the likely impact of any such cutbacks on taxpayer compliance. It also directs the IRS to abide by the terms of the new four-year agreement it signed with the Free File Alliance, which bars the IRS from competing in the market for tax return preparation software. Moreover, under the act, the IRS Oversight Board, and the National Taxpayer Advocate are required to develop a five-year plan for taxpayer services that balances strategic goals for enforcement and service and submit the report to the Committees no later than April 14, 2006.

Issues for Congress

The Administration's budget request for the IRS in FY2006 raised several policy issues. Each issue was tied in some way to the three principal aims of the agency's current five-year strategic plan, which was issued in July 2004: (1) continued improvement of taxpayer service; (2) strengthened enforcement of the tax laws; and (3) continued modernization of IRS's information systems. Taken together, the issues underscored the difficult tradeoffs facing Congress as it allocated limited resources among programs intended to advance the three aims at a time when the estimated tax gap and the federal budget deficit were large and growing.

Stronger Emphasis on Enforcement

The budget request made it clear that the Administration placed a high priority on improving taxpayer compliance and collecting overdue taxes.[15] It called for a rise in spending on enforcement of 8% relative to the amount enacted for FY2005 but decreases in spending of 1.1%for taxpayer service, 2.1% for the BSM program, and 41.5% for administering the health insurance tax credit. FY2006 marked the sixth fiscal year in a row that the IRS asked Congress to fund an increase in enforcement staff. There were no increases in staffing before FY2005 because the rises in funding for enforcement enacted in FY2001 through FY2004 was used largely to cover unbudgeted increases in operating expenses or to address other priorities.[16] In testimony before the House Ways and Means Subcommittee on Oversight, IRS Commissioner Mark Everson stated that if his agency's requested budget for enforcement were enacted, the IRS would be able to increase the audit rate for mid-size corporations from 7.6% in FY2004 to 16% in FY2008, close 50% more delinquent accounts in FY2008 than in FY2004, and raise the audit rate for individual taxpayers with taxable incomes between $250,000 and $1 million from 1.5% in FY2004 to 2.8% in FY2008.[17]

The Administration sought more resources for tax law enforcement for several reasons. First, a failure to pay taxes owed was becoming a significant problem. According to the latest estimate by the IRS, the gross tax gap—which is the difference between federal taxes owed on legal sources of income and federal taxes on that income paid on time—in the 2001 tax year amounted to somewhere between $312 billion and $353 billion.[18] By contrast, the gross tax gap was estimated to have been about one-third that level in 1992: $110.1 billion to $127.0 billion.[19] Tax evasion is a serious policy issue because if left unchecked, it can undermine the fairness and integrity of the tax system, waste considerable economic resources, and hamper the performance of the economy.

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[15] Treasury Department, *Budget in Brief FY2006*, pp. 11-13.

[16] U.S. Government Accountability Office, *Assessment of Fiscal year 2006 Budget Request and Interim Results of the 2005 Filing Season*, report GAO-05-416T (Washington: April 14, 2005), p. 9.

[17] See prepared statement of IRS Commissioner Mark Everson delivered at a hearing of the House Ways and Means Subcommittee on Oversight held on April 13, 2005. Available at http://waysandmeans.house.gov/hearings.asp.

[18] See IRS Fact Sheet FS-2005-14, issued on March 29, 2005. The low estimate of the gross tax gap reflects tax assessments made after taxpayers have appealed rulings by the IRS that taxpayers actually owe more than they claim on their tax returns. By contrast, the high estimate is based on the results of audits of tax returns. For more information, see archived CRS Report 95-41, *Tax Gap: Concept and Relationship to Enforcement*, by James M. Bickley. (Available from the author to congressional clients upon request.)

[19] Ibid., p. 3.

Second, from the mid-1990s through the first few years of the third millennium, IRS's resources for enforcing compliance with tax laws and regulations declined while the volume of tax returns grew. From FY1996 to FY2003, the size of the IRS workforce engaged in enforcement activities steadily fell from 26,061 in FY1996 to 19,322 in FY2003, a drop of 26%. (The downward trend ended in FY2004 when the total number of revenue agents, revenue offices, and special agents rose to 20,863.) Meanwhile, between 1995 and 2003, the number of individual income tax returns filed rose from 116.5 million to 130.8 million, a gain of 12%, and the typical return became more complex owing to new tax provisions and a proliferation of sophisticated new financial instruments. A predictable result of these trends was a sharp drop in the share of individual and corporate tax returns subject to examination over the same period: the overall audit rate for individual taxpayers was 0.65% in FY2003, down from 1.67% in FY1996; for all corporations with assets of $10 million or more, the audit rate stood at 12.08% in FY2003, down from 25.33% in from FY1996.

Third, spending on enforcement has the potential to generate a large return on investment. Through its enforcement activities, the IRS collects taxes that otherwise might go unpaid. In addition, the threat of investigation and prosecution inherent in enforcement activities deters some individuals from engaging in tax evasion, leading to higher levels of current-year tax payments than otherwise would be the case. In FY2004, IRS's enforcement activities yielded $43.1 billion in additional revenue, an increase of $5.5 billion (or 15%) from FY2003.[20] Without providing supporting evidence, the Administration argued in its budget request for the IRS in FY2006 that spending $265 million more on enforcement in FY2006 than in FY2005 would yield nearly $1.2 billion in additional revenue by FY2008. Research on the efficacy of tax law enforcement activities suggests there is no incontestable causal connection between spending on enforcement and the amount of revenue collected.[21] A recent report by TIGTA questioned the methodology used by the IRS to project a return of $4.40 in FY2008 for every dollar spent on enforcement in FY2006 above the level of FY2005.[22]

The proposed increase in spending on enforcement raised at least three policy questions that might be of interest to lawmakers: How much additional revenue would be collected as a result of the increase, and over what period would it be collected? Could of its overall budget devoted to enforcement without compromising taxpayer service or its commitment to protect and uphold taxpayer rights? Should Congress set enforcement goals for the IRS and make its budget for enforcement contingent on tangible progress toward achieving those goals?

Use of Private Debt Collection Agencies

As part of its strategy for improving taxpayer compliance and shrinking the gross tax gap, the Bush Administration sought in its budget requests for FY2004 and FY2005 the legal authority to hire private debt collection agencies (PCAs) to help the IRS collect certain delinquent individual tax debt.[23] The IRS gained the authority with the passage of the American Jobs Creation Act of 2004. Under the act, the IRS is authorized to enter into contracts with PCAs to pursue such debt. Overdue taxes collected through the firms' collection activities are to be put into a revolving fund

[20] See testimony of IRS Commissioner Mark Everson before the House Ways and Means Subcommittee on Oversight on April 13, 2005, at http://waysandmeans.house.gov/hearings.asp.

[21] Martin A. Sullivan, "Rx for the IRS: Spend and Tax," *Tax Notes*, Nov. 1, 2004, p. 649.

[22] U.S. Treasury Department, Treasury Inspector General for Tax Administration, *A Better Model Is Needed to Project the Return on Additional Investment in Tax Enforcement*, reference no. 2005-10-159 (Washington: September 2005), pp. 4-9.

[23] For more details on the Administration's proposal, see CRS Report RL33231, *The Internal Revenue Service's Use of Private Debt Collection Agencies: Current Status and Issues for Congress*, by Gary Guenther.

from which the PCAs will be paid for their services up to 25% of the amount collected. The IRS is soliciting bids for the first phase of the private debt collection initiative. It intends to award three contracts in February 2006 and launch a limited collection program involving the three contractors the following June. All firms approved by the General Services Administration to undertake debt collection for federal agencies under Federal Supply Schedule 520-4 are eligible to submit bids. If no problems arise in the first phase of the initiative, the number of contractors could be expanded to 12 in January 2008.

The proposal to allow the IRS to use PCAs has been controversial since it was first unveiled. Critics contend that the use of PCAs would violate the well-established and widely accepted principle that the collection of taxes is an inherently governmental function, threaten taxpayer privacy, undermine the security of IRS jobs, and serve as an invitation to taxpayer abuse by giving private debt collectors a financial incentive to use aggressive tactics with the taxpayers they contact. Supporters of the proposal retort that these concerns are largely unfounded, and that the proposed use of PCAs plan offers several advantages over hiring additional IRS staff to pursue the targeted individual tax debt. First, no appropriated funds would be used to pay for the services rendered by the PCAs. Second, the private collection agencies would augment and not replace the IRS's own collection staff. Finally, the use of PCAs would enable the IRS to focus its enforcement resources on more legally challenging cases of tax evasion with potentially higher payoffs.

Some Members of Congress remain opposed to IRS's private debt collection initiative even though it is just beginning to take shape. In the House debate over H.R. 3058, Representatives Chris Van Hollen and Rob Simmons introduced an amendment (H.Amdt. 418) that would have prohibited the IRS from using any appropriated funds to enter into, implement, or manage contracts with PCAs in FY2006. The amendment was withdrawn after a congressional supporter of the initiative threatened to raise a point of order against it. A similar amendment did not surface during the Senate's debate over its version of H.R. 3058.

The IRS initiative raised the important question of whether PCAs can collect this debt more efficiently and effectively than IRS enforcement staff without violating taxpayer rights. Congress may wish to focus on this question as it oversees the implementation of the initiative.

Proposed Cuts in Taxpayer Service

Although the Administration said one of the major aims of its FY2006 budget request for the IRS was to improve taxpayer service, it called for a net reduction in spending on this service of $38.5 million in FY2006, or 1.1% below the amount enacted for FY2005. In reality, the Administration sought a gross cut of $134 million in the budget for taxpayer service, but it intended to use more than $95 million of that savings to cover expected increases in the cost of labor, materials, postage, and rent.[24] The proposed net reduction came on top of a drop in spending for this purpose of $104 million in FY2005 relative to FY2004. Senior IRS officials contended that the proposed cut in spending on taxpayer service was justified for two reasons. First, usage of IRS taxpayer assistance centers (TACs), the IRS TeleFile service, and the IRS toll-free telephone help line had declined in recent years as more and more taxpayers access the IRS website to obtain needed tax forms and filing instructions and file tax returns electronically.[25] Second, the cost of

[24] GAO, *Assessment of Fiscal Year 2006 Budget Request and Interim Results of the 2005 Filing Season*, pp. 7-8.

[25] See the written testimony delivered by IRS Commissioner Mark Everson at a joint hearing held by the House Ways and Means, Appropriations, and Government Reform Committees and the Senate Finance, Appropriations, and Homeland Security and Governmental Affairs Committees on May 19, 2005: U.S. Congress, Joint Committee on

assisting taxpayers and processing returns was much lower online than in person or over the telephone.

Some were concerned that further cutbacks in the budget for taxpayer service would reverse some of the advances in taxpayer service that had occurred since the passage of RRA98.[26] These advances included improved responses by IRS staff to taxpayer questions over toll-free telephone lines and expanded access to a number of self-serve options over the telephone and through the IRS website aimed at simplifying the filing of tax returns and payment of taxes.

Over the first eight months of 2005, senior IRS officials announced or took several steps intended to cut $134 million from spending on taxpayer service in FY2006. One such step was a plan announced in May 2005 to close 68 out of 400 taxpayer assistance centers (TACs) nationwide by the end of 2005. IRS Commissioner Everson estimated that the closures could result in a cost savings of $50 million to $55 million in FY2006.[27] TACs provide taxpayers with a wide variety of walk-in services, including interpreting tax laws and regulations, preparing individual tax returns, resolving concerns about taxpayer accounts, and accepting payments. Two other planned steps were the elimination of electronic tax law assistance for domestic taxpayers and practitioners and a 20% reduction in the weekly hours of operation for toll-free telephone assistance; the estimated cost savings from these steps totaled $18 million in FY2006.[28] In August 2005, the IRS ended its TeleFile service, which made it possible for taxpayers to file tax returns using a telephone; the measure is expected to save up to $5 million in FY2006.

The proposed reduction in spending on taxpayer service in general and the proposed closure of a number of TACs in particular drew sharp criticism from a variety of players in the annual appropriations cycle for the IRS, including the IRS Oversight Board, the National Taxpayer Advocate, the National Treasury Employees Union, and certain Members of Congress. A major concern of critics was how the loss of 68 TACs and a reduction in toll-free telephone assistance would affect compliance by those in greatest need of assistance, especially the elderly, low-income households, and immigrants. This concern so galvanized congressional critics that they inserted a provision (section 205) in the enacted version of H.R. 3058 that bars the IRS from using any of the funds appropriated for FY2006 to reduce taxpayer services until TIGTA completes a study on how the proposed reductions would affect taxpayer compliance. In addition, the FY2006 defense appropriations bill (H.R. 2863) passed by Congress in December 2005 contained a provision that prohibits the IRS from reducing the hours of its toll-free telephone assistance "below the levels in existence during the month October 2005."[29]

Responding to congressional concerns, the IRS announced in late July that it was suspending the decision to close 68 TACs by the end of 2005 until Congress had approved a budget for the agency in FY2006.[30] In early November, a senior IRS official disclosed that the agency would not

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Taxation, *Joint Review of the Strategic Plans and Budget of the Internal Revenue Service, 2005,* 109th Cong., 1st sess., JCS-6-05 (Washington: GPO, 2005), pp. 8-9.

[26] Allen Kenney, "Deja Vu? Bush Wants $500 Million for IRS to Toughen Up in 2006," *Tax Notes*, Feb. 14, 2005, p. 748.

[27] Kurt Ritterpusch, "Everson Defends Proposed Services Cuts, Says IRS not Protected from Fiscal Realities," *Daily Report for Executives*, Bureau of National Affairs, April 8, 2005, p. G-1.

[28] Stephen Joyce, "IRS Pushes for $134 Million in Service Cuts; Agency Claims Alternatives Will Meet Needs," *Daily Report for Executives*, Bureau of National Affairs, Aug. 17, 2005, p. G-4.

[29] Diane Freda, "Service Backs Off Plan to Reduce Hours of Phone Help Line in Face of Legislation," *Daily Report for Executives*, Bureau of National Affairs, Jan. 24, 2006, p. G-4.

[30] Stephen Joyce, "IRS Postpones Decision to Close TACs Until 2006 Budget Process Completed," *Daily Report for Executives*, Bureau of National Affairs, Aug. 1, 2005, p. G-11.

close any TACs before March 1, 2006.[31]In addition, the IRS is reported to have abandoned its plan to reduce the daily hours of its toll-free telephone assistance starting on January 23, 2006.[32]

The Administration's proposed reduction in spending on taxpayer service in FY2006 raised the issue of how the reduction would affect taxpayer compliance over time. Some lawmakers were concerned that the planned cuts in taxpayer service would lead to more individuals failing to fulfill their legal obligations under the tax code even if more money were spent on enforcement. Although senior IRS officials argued that compliance could only improve by shifting funds from taxpayer service to enforcement, they provided no hard evidence to support this claim during congressional action on the Administration's budget request for the IRS. One question lawmakers may wish to address as they oversee IRS operations and its use of appropriated funds concerns what the proper balance between tax law enforcement and taxpayer service might be.

Status and Future of the Business Systems Modernization Program

The Administration's budget request for the IRS in FY2006 also was intended to support the strategic goal of "modernizing the IRS through its people, processes, and technology." Critical to this effort, in the view of many, is the BSM program, which seeks to upgrade IRS's antiquated collection of computer systems through targeted investments in new information systems designed to handle with greater efficiency such crucial functions as financial management, the processing of tax returns, and the release of refunds. Congress first created an appropriations account for BSM in FY1998, and the program began the following year. Initially, it was envisioned as a 15-year venture whose total cost would not exceed $8 billion. Through FY2006, a total of $2.1 billion has been appropriated for BSM. No appropriated funds may be spent until the House and Senate Appropriations Committees have approved an annual BSM expenditure plan submitted by the IRS. The annual appropriation for BSM has been declining since it peaked at $405.6 million in FY2002: the amount enacted for FY2006, $199 million, is 2% below the amount enacted for FY2005 ($203 million), which was 47.5% below the level of funding authorized for FY2004.

The decline in funding for the program in recent fiscal years reflects considerable doubt in Congress that IRS management is capable of taking the steps needed to improve the program's performance and rein in its cost. From the start, the BSM program has been plagued by cost overruns and schedule delays for key projects. This doubt and related concerns influenced congressional consideration of the Administration's FY2006 budget request for the program.[33]

Nonetheless, the BSM program is beginning to yield technological advances that could yield significant benefits for taxpayers and the IRS. The advances should eventually enable taxpayers to file and retrieve increasing volumes of information electronically and the IRS to reduce its backlog of collections cases and gain immediate access to financial information needed to enforce compliance with tax laws and regulations. Since 2004, the IRS has deployed the following information systems developed through the BSM: (1) the Modernized E-File, which is intended to allow large and small firms and tax-exempt organizations to file their tax returns electronically; (2) E-Services, which allows most taxpayers and tax practitioners to conduct business with the IRS electronically; (3) the Customer Account Data Engine, which will gradually replace the

[31] Stephen Joyce, "No IRS Taxpayer Assistance Centers Will Close Before March, Magrante Says," *Daily Report for Executives*, Bureau of National Affairs, Nov. 3, 2005, p. G-3.

[32] Freda, *Daily Report for Executives*, p. G-4.

[33] Senate Committee on Appropriations, *Transportation, Treasury, the Judiciary, Housing and Urban Development, and Related Agencies Appropriations Bill, 2006*, pp. 138-139.

agency's outmoded computerized database of taxpayer information and is currently used to process 1040EZ returns for single taxpayers with refunds; and (4) the Integrated Financial System, which replaces key aspects of IRS's core financial systems and functions as its new internal accounting system.[34]

Proposals to lower funding for the BSM program raise some interesting policy issues. Some analysts are concerned that continued reductions in the budget for BSM are bound to lessen IRS's chances of achieving its primary goals for the program and cause avoidable delays in implementing certain planned technology improvements.[35] In addition, further reductions may adversely affect taxpayer service and IRS enforcement activities in the long run. Raymond Wagner, the Chair of the IRS Oversight Board, stated in congressional testimony that the BSM program is the "key to improving customer service and enforcement," and that the program should be expanded "not only to reduce costs and speed up delivery time, but to avoid a catastrophic collapse of the IRS's archaic legacy computer systems.[36]

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[34] GAO, *Assessment of Fiscal year 2006 Budget Request and Interim Results of the 2005 Filing Season*, p. 17.

[35] Allen Kenney, "Budget Issues Hamstring Modernization, IRS Officials Say," *Tax Notes*, Nov. 22, 2004, pp. 1084-1085.

[36] See prepared testimony of Chairman Wagner at a hearing held by the House Ways and Means Subcommittee on Oversight on April 13, 2005. Available at http://waysandmeans.house.gov/hearings.asp.